

CSR as a Risk Management Strategy for Capital Budget Projects

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Abstract

Globalizations, Networked world, Social media have added new challenges to Business firms for integrating Environmental, Social and Political(ESP) risks into strategic management decisions. Despite increased ESP risks and associated costs, most companies do not currently integrate these issues into Operational and Capital investment decisions. With Corporate Social Responsibilities (CSR) programmes, corporations can better manage and subsequently mitigate impacts of ESP risks. CSR programmes can positively impact risk management by providing intelligence about what these risks are and offering effective means to respond to them. It also offers a practical method for integrating these risks into the financial analysis necessary for a robust enterprise risk management system that improves investment and operations decisions. This paper develops a conceptual framework for companies to manage the emerging ESP risks of Capital Budget Projects and using CSR programs to manage these risks.

CSR as a Risk Management Strategy for Capital Budget Projects

Businesses are an integral part of the communities in which they operate. Communities as a major stakeholder via their political representatives, activists, NGOs, pressure groups affect activities of businesses. For long-term success corporate leaders have to build good relations with a wide range of stakeholders, particularly with civil society and political leadership. Companies can contribute to shareholders' wealth and to overall societal wealth by considering the effect they have on the world at large when making strategic Capital Budget decisions. General public has high expectations of the large companies in terms of responsible behaviour. Consumers expect goods and services to reflect socially and environmentally responsible business behaviour at competitive prices. Nowadays, shareholders also expect enhanced financial performance that integrates social and environmental considerations both in terms of risks and opportunities.

Capital Budget Projects have the potential to not only significantly add economic value to organizations but also significantly impact environments, communities and economies. Generally Capital Budget Projects may face ESP risks, health risks and safety risks, liability risks and ultimately, reputational risks, the management of which is central to the companies' long-term success and financial viability. At times these risks manifest in conflicts or disputes between companies and local communities. If not managed properly, the ESP risks can result in disrupting or halting project operations and lead to legal complications and reputational impacts that threaten the overall success of the project and organization. To avoid high scrutiny from regulators, civil society, pressure groups and financiers, leadership is required to allocate more resources to managing ESP risks.

Global Operating Model

Today's business operates under dynamic integrated ecosystem with conflicting needs and expectations of Company, Government and Civil society. Figure 1 depicts relationship among these three entities. Each of them has its own area of influence and various levers to influence others. Each entity has its own levers to influence other entity. Each entity employs its levers to trigger desired changes in other sectors or overall system. For example, civil societies in campaign such as protection of tribal rights or forest land while building dams triggers for changes in corporate/ business and Government behaviors through protests, boycotts, pressures, partnering and perceptions management. The pull and push of among three entities constitute dynamic systems within which companies must now operate while mitigating new risks and looking for new business growth opportunities.

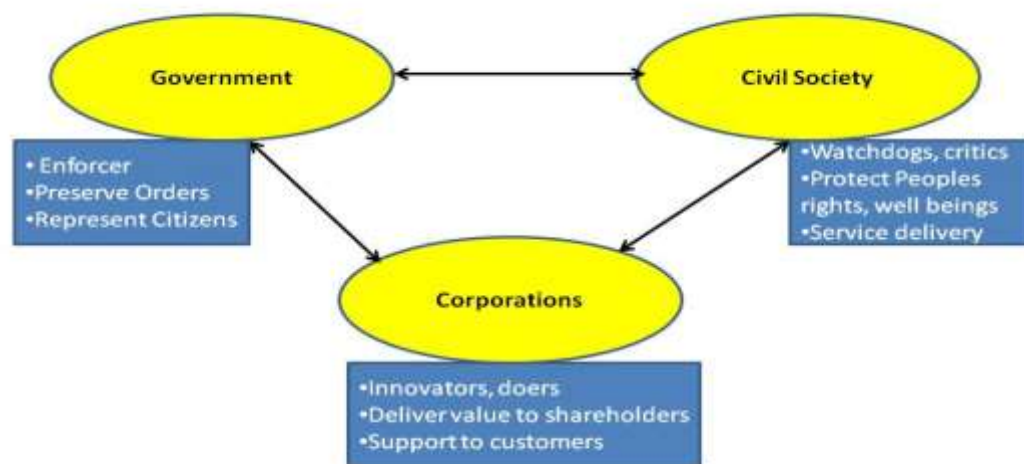


Figure 1: Global Operating Environment
Source: Kytte, B and Ruggie, J. G. (2005)

Capital Budget Projects

Capital Budgeting is the process by which the corporations decide on long-term investments. Capital Budgeting projects also known as Capital Projects are potential long-term investments which are expected to generate cash flows over several years. Capital Projects are long-term investment made in order to build upon, add or improve on capital-intensive projects. Capital projects require the use of large capital, resources both financial and labor, long and costly planning for execution. Setting up a Steel Plant or oil refinery, Building a Nuclear Power station, Construction of Dam, Implementing ERP or enterprise wide applications in business firm etc are examples of Capital projects. These projects are capital intensive and take a long duration for completion.

Capital Budgeting is an important part of strategic decision-making in every enterprise because new investment projects essentially affect future economic results and the enterprise's prosperity. Success of new capital projects dramatically contributes to the growth of an enterprise's efficiency. On the other hand, failure can lead not only to a considerable decline in efficiency, but it can even jeopardize its future existence. Success or failure of capital projects depends on

the quality of the process of preparing, evaluating and selecting these projects. Generally evaluation and selection of investment projects is based on financial, technical and market demand & supply modeling. In the last two decades, impact of ESP on projects as an additional criterion has gained importance.

Capital Projects Risks

Large capital projects face multiple risks throughout their lifetime which impact their success. Major risks to capital projects can be classified as follows:

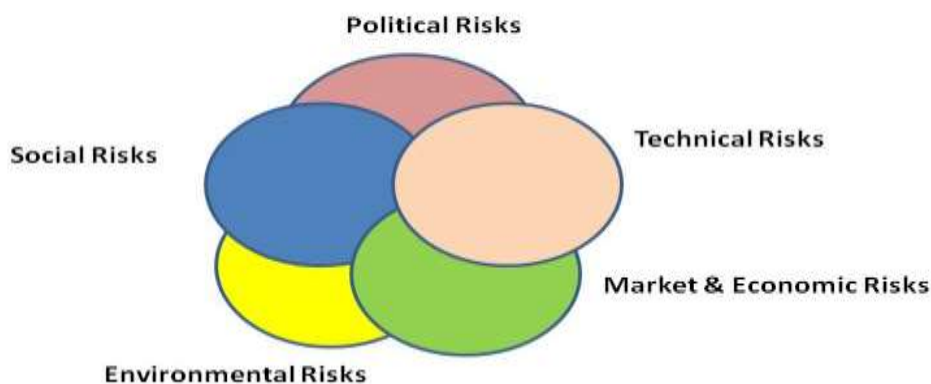


Figure 2: Prospective Capital Project Risks

(a) Technical Risks

Technical risks refer to the engineering uncertainty surrounding project operations. These risks are specific to each project and industry, and the level of uncertainty depends on the degree of novelty associated with the project. Generally, Project leadership is trained and able to handle technical risks based on their own or organization / industry's collective past experience and expertise.

(b) Market & Financial Risks

Market and Financial risks measure the part of a project's risk from macroeconomic factors such as inflation and interest rates. Market and financial risks are dependent on global and national economic conditions. A poor economy can decrease demand for a product, potentially turning a project unprofitable. Sales, marketing and financial teams have multiple proven models to forecast, evaluate and mitigate these risks.

(c) Environmental Risks

Project Environmental risks are those which arise in, or are transmitted through the air, water, soil or biological food chains, to man. Some can be reasonably well anticipated, others are wholly unsuspected at the time the technology was developed. Stringent global environmental regulations, coupled with heightened public awareness regarding protection of the environment and natural resources, has resulted in the need for comprehensive environmental risk management strategies, which not only ensure successful project delivery but also protect all stakeholders. Environmental risk assessment typically involves gathering baseline information on the “state” of the environment likely to be affected by project activities. Based on anticipated project impacts, the project identifies potential measures to avoid, minimize or mitigate these impacts.

(d) Social Risks

Social Risks are defined as challenges by stakeholders to companies’ business practices due to real or perceived business impact on a broad range of issues related to human welfare such as working conditions, environment quality, health, or economic opportunity. The consequences may include brand and reputation damage, heightened regulatory pressure, legal action, consumer boycott, and operational stoppage leading to jeopardizing short and long term shareholder value.

(e) Political Risk

Political risks can be defined as execution of political power in a way that threatens a company’s value. Political risks can be either industry or firm specific. Corporate has to continuously watch political changes and take action so that changes do not impact industry and firm’s current or future operations. Changes in the legal framework governing contracts could have a significant negative impact on the company and thus require continuous assessment and mitigation plan. The distinction between social and political risks is often blurred.

Different models for financial, market and technical analysis of Capital projects are available for management in risk mitigation planning, tracking and control. Due to their complexity, size, and location, Capital Projects often have challenging ESP issues and these are difficult to model and analyze. If not managed properly, the ESP risks can result in disrupting or halting project operations and lead to legal complications and reputational impacts that threaten the overall success of the project. ESP risks can also pose direct financial risks to organization.

Corporate Social Responsibility

CSR is not a new concept. Historically, large and medium businesses have always been helping and supporting charitable organizations. However, now business firms have moved beyond charity and regulatory compliance. CSR is a management concept whereby companies integrate

social and environmental concerns in their business operations and interactions with their stakeholders. CSR by aligning with dominant political group social vision is also used as a tool to manage changing political dynamics. CSR is generally understood as being the way through which a company achieves a balance of economic, environmental and social imperatives (“Triple-Bottom-Line- Approach”), while at the same time addressing the expectations of shareholders and stakeholders.



Figure 3 : Framework for Corporate Responsibility
Source: Prof. Dr. Alexander Bassen, Corporate Responsibility on the Cost of Capital
An Empirical Analysis 2006, University of Hamburg

CSR Framework incorporates concepts of sustainability, corporate citizenship and corporate governance and encloses them as depicted in Fig 3.

George Khoury defined CSR as “CSR is the overall relationship of the corporation with all of its stakeholders. These include customers, employees, communities, owners/investors, government, suppliers and competitors. Through effective CSR practices, organizations will: achieve a balance between economic, environmental and social imperatives; address stakeholders’ expectations, demands, and influences; sustain shareholder value.”

The benefits of CSR activities in capital project execution are hard to quantify. CSR activities help in firms’ image building, reduction of ESP risks, cost saving, trust building with stakeholders, and increased employee motivation, thus likely to help in successful execution of capital projects.

Relationship between CSR and Capital Project Risk Management

Managing risk is a central part of many corporate strategies. Corporate have built well-defined methodologies to handle financial, technical and project execution risks of Capital Projects.

However, corporate do not have well defined strategy to handle ESP risks. These risks have potential to impact reputations that take decades to build. These can also draw unwanted attention from regulators, courts, government, civil society, NGOs and the media. All have the potential to delay capital project execution. These ESP risks have the potential to lead to serious costs to the companies involved. Some of the most significant costs to companies relate to disruption of project completion, lost opportunities, and the amount of staff time spent managing existing or escalating ESP conflicts. Building a genuine culture of “doing the right thing” within a corporation can offset these risks. Shareholders, in order to protect their wealth and reputation are becoming increasingly concerned about ESP risks. A number of shareholder initiatives have occurred in recent years that are designed to raise awareness of ESP risks at a company level, and to lower investment risks.

Nowadays, CSR is not only a regulatory requirement but also about risk management. The mutual dependence of corporations and society implies that both business decisions and social policies must follow the principle of shared values, which can be achieved by strategic CSR only. CSR is not just a method of risk mitigation, but also an opportunity for value creation. Engaging in CSR activities from the corporate governance point of view lowers risks to capital projects. CSR can impact risk management positively through two main means:

- Providing intelligence about ESP issues and risks,
- Offering an effective means to respond to ESP issues and risks.

CSR projects and programs help in effective stakeholder relationships management. Managing stakeholder relationships is imperative for capital projects because if they do not effectively manage those relationships, stakeholders like regulators and civil society organizations will be likely to engage them legally or in the court of public opinion without many options or alternatives.

CSR approaches can help corporate actions so that they are more environmentally, socially, culturally, and politically responsive to the communities they impact. By addressing real and perceived community concerns during capital projects planning and design corporate proactively resolve disputes before they escalate. The practice of community relations has the potential to reduce the risk of actions such as blockades, protests, campaigns, legal suits or sabotage, thereby also reducing the costs to the company that such actions can generate. CSR leads to importance of improved prevention and management of conflict with communities.

Some CSR activities are designed to burnish the company's reputation which may be impacted due to ESP issues. CSR activities may attract new, socially-conscious customers and investors, and may strengthen the loyalty of existing customers. If a company is perceived as a good corporate citizen, that may make customers and suppliers happier to work with the company, and employees happier to work for it. Thus CSR activities indirectly help in customer, partners and employee retention.

CSR approach to managing ESP risks is based on partnering with all major stakeholders to develop new standards for addressing social and environmental issues in the absence of legal standards. Large Global energy and mining companies have participated in several collaborative

attempts to address problems associated with governmental capacity, transparency and accountability.

Stakeholder Management Model

Majority of Corporate work for several stakeholder groups, namely shareholders, employees, consumers, suppliers and trade customers as business partners, federal and local governments, local communities, Non-Government Groups, pressure groups, media, academics and research & development institutes. These stakeholders can influence the success and failure of capital projects. Corporate define risk mitigation strategy for each stakeholder depending on the level of influence they have on the success of a project.

ESP Stakeholder Management consists of not only managing stakeholders but also managing stakeholder relationships. The stakeholder management's main objective is the dissemination of information to stakeholders through public relations or community relations on decisions already made without completing the feedback loop. This way of managing stakeholders is ineffective in global operating environments. Managing stakeholder relationship requires closing the loop. It means truly engaging stakeholders (figure 4). The diagram shows a stakeholder engagement model developed by the World Bank group (Calow, Morris and Lawrence, 1999).

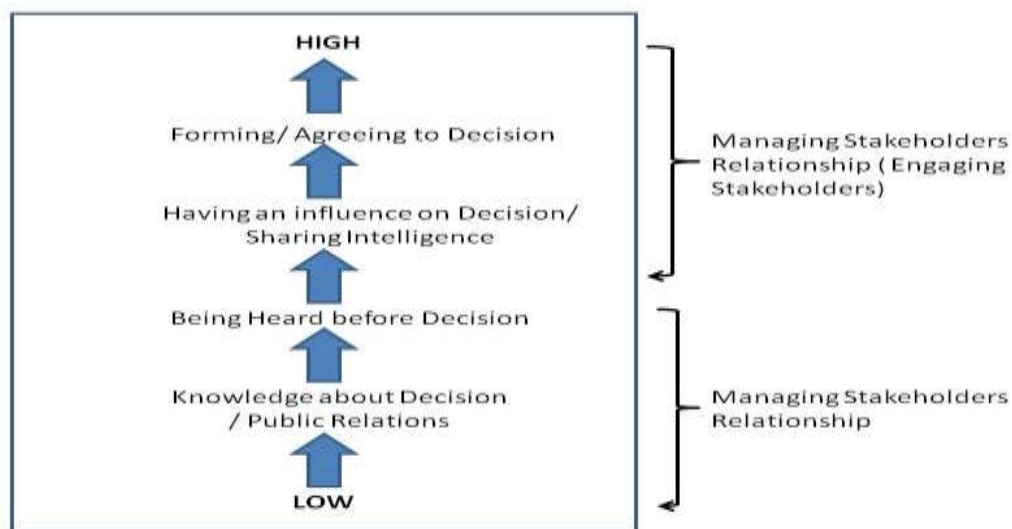


Fig 4: Stakeholder Engagement Model Source: Calow, Morris and Lawrence (1999:25)

Stakeholder engagement can help companies develop strategic CSR programs which are acceptable to major stakeholders. CSR expenditure which is based on ESP risks will not only enhance firms reputation, but do so in ways that could benefit the company's operations in the long run and add to its bottomline.

Social and Political Risk Integration Model

Tamara Bekefi and Marc J. Epstein have defined Social and Political Risk Integration Model. By extending the model, a detailed process is to identify and assess ESP risks in a manner that is relevant to financial decision-making is described in Fig 5.

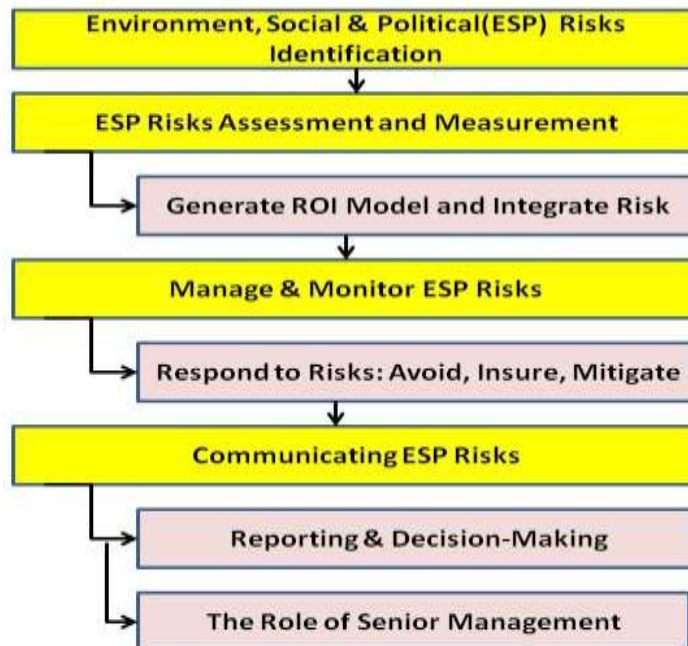


Figure 5: Social and Political Risk Integration Model
Tamara Bekefi and Marc J. Epstein, Integrating Social and Political Risk Into ROI Calculations, 2011, Wiley Periodicals, Inc

ESP Risk Identification

To effectively manage ESP risks, the first step is to identify risks that projects face from various sources, and handle them within a larger risk management framework. Once risks have been identified, risk profile can be developed which will allow decision-makers to reduce unwanted surprises and minimize the negative effects of external factors on the business.

Developing a risk profile has two elements:

- Identify enterprise risk sources. Sources of ESP risks for capital projects are locations and their socio political issues, Reaction of society or a group of people affected by, or who believe they will be affected by, business activities, employee base that is deemed unacceptable to society, product, technology etc.
- Identify Industry/ Company/ Project specific ESP risks. Some of the sample ESP issues which become risks to capital projects are enumerated I table 1.

Development and use of ESP database over years provides help in risk identification. Intelligence and study of industry, competitors' risks and mitigation plan also help in identification of risks. To build Risk database Companies are expected to identify and document potential adverse impacts and risks for each stage of the project life-cycle. Prior to project financing, large financial institution like to audit each companies environmental and social management system and capacity to address identified risks.

Environmental	Social	Political
Pollution Healthcare and Waste Management Water Consumption Hazardous waste management Green House gases emission and control Ecosystem replenishment Community exposure to diseases due to project Emergency preparedness and response Resettlement and livelihood restoration Protection and conservation of bio diversity	Labor laws Religious, ethnic and language conflicts/ issues Cultural protection Failure to meet community expectations Class divide Terrorism Mafia and criminal activities Civil unrest surrounding project site	Trade Restrictions Corruption Regulatory changes Weak legal systems Political instability Leadership crisis Political unrest Centre-State relations Religious issues turning political Armed insurgency Poverty and lack of opportunity

Table 1: Sample Environmental, Social and Political Risk

Assessing & Measuring ESP Risks

Business resource allocations are primarily based on Return on Investment (ROI) calculations. For a complete analysis and improved operational and capital investment planning, ROI calculations must also include ESP risks, to make them more explicit and relevant. After identifying the ESP issues that could affect the company, and compiling those issues into a comprehensive risk profile, metrics must be developed for each issue to assess its relative potential impact. One of the main aims of quantifying ESP risks is to integrate them into a financial model, thereby incorporating ESP issues into traditional risk analysis. Monetizing the savings and costs associated with each issue provides a measure of the costs of ESP risk. Any monetary savings resulting from participating in a socially responsible activity represents the issue benefit, which is generally assigned a positive value.

Measurement of ESP risks is a seven-stage process:

- a) Calculate the benefit associated with each issue that may generate risk: For instance, shifting operations to cheaper but political/socially unstable location could save significant money to a company's by employing cheaper labor.
- b) Calculate the potential costs associated with each ESP risk, including reputation costs. Potential costs also include cost of CSR programs / projects planned to mitigate risk.
- c) Estimate the probability that each risk will materialize. This is based on past experience and expert opinion.
- d) Multiply the potential cost of each risk by its expected probability of materializing to calculate the expected value of each risk.
- e) Estimate when, over time, the risk may emerge. Calculate the net present value (NPV) of the risk. This is also based on past experience and expert opinion.
- f) Aggregate the NPVs of all ESP risks. Insert as a line item in Financial ROI calculations.
- g) Calculate the expected value of the ROI.

Managing and Monitoring ESP Risks

Unlike financial risk, which can usually be shared or transferred, this is often not possible with ESP risks in an environment where firms are often held liable for their suppliers' misdemeanors, either in the court of law or public opinion.

Managing ESP risk includes executing CSR policies and programs to respond to risks as they occur, to avoid or mitigate identified risk. Effective risk management requires both for monitoring of ESP risks and communication to management of changes in their levels. CSR activities help organizations gain public awareness. It is essential that the CSR activities are in line with all other business activities in the corporation. ESP monitoring for capital projects involves analysis of stakeholder's formal and informal responses and analysis to identified and unidentified ESP risks. Response to an ESP risk can be planned by insuring against risk when possible; avoiding risk; mitigating risk or combination of three techniques.

Management has to continuously undertake risks analysis in order to develop adverse scenarios which are faced by companies. Based on analysis, management develops CSR policies and projects. The analysis should not just be focused on the company's risks, but should also cover the risks to the society. An Action Plan for the project must be established based on consultation with stakeholders, describing how risks will be mitigated and how the Performance Standards will be implemented. Action plan should be a dynamic and regularly reviewed and updated in project life cycle.

Communicating ESP Risks

Successful corporate management of ESP risks requires not only integrating such risks into management systems but also on effective communication of risks and CSR projects/ programs undertaken to mitigate risks to both internal and external stakeholders. Project staff at all levels must be appraised of senior management's commitment, for better

inclusion of ESP risks and CSR initiatives into decision-making. Internal communication ESP risks and CSR initiatives can be undertaken during internal trainings, communication via intranet, bulletins, staff meetings and town hall meetings. External communication can be via PR, participation in meets & conferences use of print, radio & TV and social media both formally and informally.

CSR Initiative to reduce ESP Risks

Corporate can choose CSR initiatives to mitigate ESP risks to focus on improving condition of communities, by a structured way of defining the capacity of a community in following assets:

- a) **Developing Human Capital:** Investing in skills development, knowledge, ability to work, and health in workplace, supply chain and community around or impacted by capital project.
- b) **Build Social Capital:** Resources that people draw on to pursue their life goals (e.g., networks, organizations, relationships)
- c) **Provide Financial Capital:** Financial resources (e.g., savings, assets, income, social security, health insurance) used to pursue livelihood objectives
- d) **Protect & refurbish Natural Capital:** Natural resources and environmental services
- e) **Build Physical Capital:** Investing in infrastructure that supports operations and that simultaneously expands local capacity (e.g. communication, roads and transportation networks, water, electricity distribution etc)

Conclusion

Since businesses play a pivotal role both in job and wealth creation in society and in the efficient use of national capital, CSR) is a central management concern. It positions organizations to both proactively manage risks and take advantage of opportunities especially with respect to their corporate reputation and the broad engagement of stakeholders, (shareholders, employees, customers, communities, suppliers, non-government organizations, international organizations and others affected by a company's activities). Acting responsibly towards these stakeholders can help companies build long-lasting values for themselves. Investors and financial institutions have recognized that CSR activities that integrate broad societal concerns into business strategy and performance are evidence of good risk management capabilities. In addition to building trust with the host communities and giving companies competitive edge in attracting good customers and employees, there are countless win-win opportunities waiting to be discovered. This is because every activity in a firm's value chain overlaps in some way with social factors. The job of today's business leaders is to start thinking systematically; adapt Corporate Social Responsibility to risk management and stop being defensive.

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